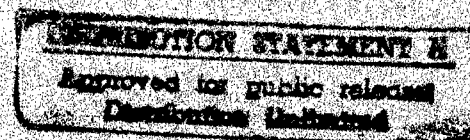


April 1997

DEFENSE RESTRUCTURING COSTS

Information Pertaining to Five Business Combinations



19 90 403 055

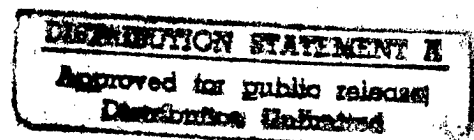
National Security and
International Affairs Division

B-276318

April 1, 1997

The Honorable Ted Stevens
Chairman
The Honorable Daniel K. Inouye
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable C. W. Bill Young
Chairman
The Honorable John P. Murtha
Ranking Minority Member
Subcommittee on National Security
Committee on Appropriations
House of Representatives



Section 8115 of the Fiscal Year 1997 Department of Defense (DOD) Appropriations Act¹ requires us to examine restructuring costs² of defense contractors involved in business combinations since 1993. In response, this report provides information on restructuring costs, including specific costs associated with workforce reductions and the services provided to workers affected by business combinations. It also identifies other funds used to help laid-off workers find new employment and describes why the effectiveness of restructuring costs used to assist laid-off workers in gaining new employment cannot be determined. In addition, the report discusses the extent of savings achieved from the business combinations relative to restructuring costs paid by DOD.

To accomplish our work, we focused on five defense contractor business combinations: (1) Hughes Aircraft Company's acquisition of General Dynamics Corporation's Missile Operations, (2) the United Defense Limited Partnership (UDLP) between FMC Corporation's Defense Systems Group and Harsco Corporation's BMY Combat Systems Division, (3) Martin Marietta Corporation's acquisition of General Electric Company's aerospace and other business segments, (4) Northrop Corporation's acquisitions of the Grumman Corporation and the Vought Aircraft Company to form the Northrop Grumman Corporation, and

¹Public Law 104-208, September 30, 1996.

²Restructuring costs cover a wide range of expenses, such as personnel relocations, severance pay, early retirement incentives, equipment relocations, plant rearrangements, and facility closures.

(5) the merger of the Lockheed Corporation and the Martin Marietta Corporation to form the Lockheed Martin Corporation.

Results in Brief

The five business combinations had spent about \$849 million at the time of our review for such restructuring activities as the disposal and relocation of facilities and equipment, consolidation of operations and systems, employee relocation, and workforce reductions. Of this amount, the business combinations spent about \$89 million, or 10 percent, on workforce reductions, which consisted of severance pay, temporary continuation of health benefits, and outplacement services. About 15,000 workers left the companies as a result of the business combinations. Severance pay represented about 89 percent of total worker benefits. Expenditures for services to assist laid-off workers find reemployment totaled \$4 million.

In addition to those services provided from restructuring costs, we identified about \$48 million in Department of Labor (DOL) grants made either directly to the contractors or to locations where workers were laid off as a result of the business combinations or normal downsizing. Moreover, there were at least 163 federally funded programs and funding streams that provided employment training assistance, of which 9 are targeted specifically for laid-off workers. During fiscal year 1996, funding for one of the nine programs totaled about \$1.1 billion; however, no readily available means exist to determine the extent to which the majority of these funds, which are distributed at the state and local levels, were used to assist workers affected by the five business combinations. The business combinations were also providing some services that were not included in restructuring costs, but rather were paid as normal overhead costs.

We were unable to determine the effectiveness of services for workers laid off specifically as a result of the business combinations because information critical to making such a determination—including reemployment rates, workers' previous and current salaries, and satisfaction with their new jobs—are not maintained by the business combinations and are not readily available from other sources. In general, little empirical information is available on specific services that are the most useful and cost-effective.

The Defense Contract Audit Agency (DCAA) estimated that, as of September 30, 1996, DOD had reimbursed these business combinations about \$179 million toward its share of the \$849 million the combinations

had incurred for restructuring activities. DCAA also estimated that DOD realized restructuring savings totaling \$347 million from the business combinations during the same period. Therefore, for every \$1.00 DOD has paid so far in restructuring costs, DOD has realized savings of \$1.93. DOD officials believe that additional savings have been realized, but they did not document those savings. An industry representative also commented that these estimates cover only the period through September 1996, and therefore, do not reflect savings that may be realized in future periods. It should be noted, however, that the estimates also do not reflect any costs that may be incurred in subsequent periods. Finally, these estimates do not reflect DOL grant expenditures or any assistance from other federal programs or funding streams.

Of the \$179 million paid to the business combinations, DCAA determined that \$18 million, or about 10 percent, represented additional costs to DOD as a result of the July 1993 decision to pay for restructuring costs on certain contracts transferred from one company to another after a business combination. The percentage of additional costs relative to the total amount paid may not be the same for future business combinations.

Background

Prior to July 1993, DOD had a long-standing practice of not permitting defense contractors to charge restructuring costs to flexibly priced³ contracts that were transferred⁴ from one contractor to another as a result of a business combination. The rationale for this practice was that DOD should not have to pay increased costs merely because one contractor is combined with another contractor.

In July 1993, DOD changed its long-standing practice and uniformly began permitting defense contractors to charge restructuring costs to transferred flexibly priced contracts after a business combination, provided (1) the restructuring costs were allowable under the Federal Acquisition Regulation (FAR)⁵ and (2) a DOD contracting officer determined the business combination would result in overall reduced costs to DOD or preserve a critical defense capability. According to DOD officials, this

³Flexibly priced contracts are a family of contracts under which the total amount paid to the contractor is dependent on the allowable costs the contractor incurs in performing the contract.

⁴The transfer of contracts from one contractor to another involves a process called novation. The novation process requires a written agreement executed by the seller, buyer, and government, in which the government agrees to the transfer of its contracts.

⁵The FAR contains guidelines for determining whether a particular restructuring cost is an allowable charge to a government contract. It also describes certain organization costs, such as legal and consulting fees applicable to business combinations, that cannot be charged to a government contract.

action was consistent with the flexibility provided by federal regulations. However, when asked, DOD officials stated that they were unaware of any instances where DOD had previously allowed restructuring costs to be charged to transferred contracts.

As a result of its concerns over the payment of these costs, the Congress enacted section 818 of the National Defense Authorization Act for Fiscal Year 1995,⁶ which prohibited payment of restructuring costs to a defense contractor until a senior DOD official certified that projections of restructuring savings from the business combinations were based on audited cost data and should result in overall reduced costs to DOD. Section 818 also required the Secretary of Defense to report to the Congress on DOD's experience with defense contractor business combinations, including whether savings associated with each restructuring actually exceed restructuring costs.⁷

The Congress modified authority for paying restructuring costs in section 8115 of the Department of Defense Appropriations Act for Fiscal Year 1997 by prohibiting payment of those costs for business combinations occurring after September 30, 1996, unless (1) restructuring savings for DOD were projected to exceed allowed costs by a factor of at least two to one or (2) the projected savings to DOD exceeded the costs allowed and the Secretary of Defense determined the business combination would result in the preservation of a critical capability, and (3) the DOD restructuring report for 1996 was submitted.

As of December 31, 1996, the Under Secretary of Defense (Acquisition and Technology) had certified five business combinations for restructuring payments.⁸ Table 1 shows the certification dates for the business combinations in our review. We also included in our review the Hughes-General Dynamics business combination because DOD has included the combination in its restructuring reports to the Congress. However, the Hughes-General Dynamics combination did not go through the certification process because the combination occurred prior to enactment of the Defense Authorization Act for Fiscal Year 1995.

⁶Public Law 103-337, October 5, 1994.

⁷Section 818 required DOD to submit reports to the Congress on defense contractor restructuring activities for fiscal years 1995, 1996, and 1997. DOD transmitted the required reports for fiscal years 1995 and 1996 on June 18 and December 23, 1996, respectively. We subsequently refer to these reports as DOD restructuring reports.

⁸We examined four of the five certified business combinations. We did not examine Martin Marietta Corporation's acquisition of General Dynamics Corporation's Space System Division because we were already examining two other business combinations involving Martin Marietta Corporation.

**Table 1: Business Combination
Certification Dates**

Business combination	Date certified
UDLP	May 15, 1995
Martin Marietta-General Electric: ^a	
5 projects	September 19, 1995
3 projects	February 14, 1996
5 projects	September 17, 1996
Northrop Grumman	February 14, 1996
Lockheed Martin ^b	November 26, 1996

^aOne additional project is nearing certification.

^bAdditional projects are expected to enter the certification process.

The Defense Contract Management Command (DCMC) has lead responsibility for implementing DOD's restructuring regulations. According to DCMC officials, they are tracking an additional 10 defense contractor business combinations that are currently in or expected to enter the various stages of the certification process.

Restructuring Costs

For the five business combinations we examined, certified restructuring costs totaled about \$1.4 billion. At the time of our review, the companies had spent about \$849 million (see table 2). To reflect the uncertainty in the cost estimates and reduce the need for recertification if the costs increased, ceilings ranging from 104 percent to 142 percent of certified costs were established for the restructuring projects. The contractors will not be permitted to charge DOD costs in excess of the portion of these ceilings applicable to DOD.⁹

⁹Restructuring costs and cost ceilings are allocated to all of a contractor's customers. DOD's portion of restructuring costs and ceilings, therefore, depends on its share of the contractor's total business base.

Table 2: Certified Costs, Cost Ceilings, and Incurred Cost, by Business Combination

Dollars in millions			
Business combination	Certified	Ceiling	Incurred
Hughes-General Dynamics	\$366.1 ^a	\$370.0	\$327.3
UDLP	36.4	38.0	38.6
Martin Marietta-General Electric	214.5	226.3	193.4
Northrop Grumman	70.4	100.1	75.1 ^b
Lockheed Martin	686.5	724.0	214.9
Total	\$1,373.9	\$1,458.4^c	\$849.3

^aCertified costs for the Hughes-General Dynamics combination are estimated rather than certified because the business combination was not subject to the certification process.

^bIncurred costs for the Northrop Grumman combination include an estimate of cost-to-complete the restructuring.

^cDOD indicated that its projected share of the cost ceiling totaled \$809.3 million.

Restructuring after a business combination includes a wide range of activities, such as the disposal and modification of facilities, consolidation of operations and systems, relocation of workers and equipment, and workforce reductions. We grouped incurred restructuring costs for the five business combinations into broad categories (see table 3). Disposal and relocation of facilities and equipment was the largest category of total incurred restructuring costs.

Table 3: Incurred Restructuring Costs by Category

Dollars in millions	
Category	Incurred
Disposal and relocation of facilities and equipment	\$452.7
Relocation of employees	100.0
Benefits and services for laid-off workers	88.9
Consolidation of operations and systems	81.4
Restructuring planning and implementation	57.8
Other	68.5
Total	\$849.3

Costs Associated With Workforce Reductions

In total, the five companies projected that about 19,000 workers would leave as a result of the business combinations and, at the time of our review, about 15,000 had left (see table 4).

Table 4: Projected and Actual Number of Workers Leaving Organizations as a Result of the Business Combination

Business combination	Projected	Actual
Hughes-General Dynamics	6,600	6,441
UDLP	483	500
Martin Marietta-General Electric	1,171	1,222
Northrop Grumman	450	450
Lockheed Martin	10,678	6,312 ^a
Total	19,382	14,925

^aThis number will increase as Lockheed Martin completes its planned restructuring projects.

The wide variation in the number of job losses reflects differences in the nature of the restructurings. For instance, Northrop Grumman's largest restructuring project involved closing the former Grumman corporate headquarters in Bethpage, New York, resulting in the loss of about 250 employees. By contrast, the Lockheed Martin restructuring involved closing facilities in New Jersey, Pennsylvania, and Texas, and consolidating various launch operations, radar and microwave operations, and corporate laboratories.

Of the nearly \$1.4 billion in projected restructuring costs, the five business combinations estimated they would spend about \$175 million for benefits associated with workforce reductions. The costs included severance pay, temporary continuation of health benefits, and outplacement services. The estimated costs for worker benefits and services varied among the combinations, ranging from 8.6 percent to 23.9 percent of total certified restructuring costs as shown by table 5.

Table 5: Estimated Costs for Benefits and Services for Laid-Off Workers by Business Combination

Dollars in millions			
Business combination	Total certified costs	Estimated costs for benefits and services	Percent
Hughes-General Dynamics	\$366.1	\$31.5	8.6
UDLP	36.4	8.7	23.9
Martin Marietta-General Electric	214.5	24.0	11.2
Northrop Grumman	70.4	9.3	13.2
Lockheed Martin	686.5	101.1	14.7
Total	\$1,373.9	\$174.6	12.7

Of the \$849.3 million already incurred for restructuring costs, the five contractors had expended \$88.9 million, or about 10 percent, for benefits

and services for workers that left the corporations because of the business combinations (see table 6). However, Lockheed Martin has not completed its restructuring activities. Some of these activities are projected to involve additional workforce reductions, which will lead to additional severance and outplacement costs.

Table 6: Incurred Costs for Worker Benefits and Services by Business Combination

Dollars in millions

Business combination	Total incurred costs	Costs incurred for benefits and services	Percent
Hughes-General Dynamics	\$327.3	\$31.3	9.6
UDLP	38.6	5.3	13.7
Martin Marietta-General Electric	193.4	22.5	11.6
Northrop Grumman	75.1	8.8	11.7
Lockheed Martin	214.9	21.0	9.8
Total	\$849.3	\$88.9	10.5

Severance pay was by far the largest worker benefit and comprised about 88 percent and 89 percent of the estimated and incurred costs for worker benefits and services, respectively (see table 7). Each of the five business combinations provided severance pay to workers, and four provided for the temporary continuation of health benefits and other services to assist laid-off workers find new employment.

Table 7: Costs Associated With Worker Benefits and Services by Category

Dollars in millions

Benefit or service	Estimated	Incurred
Severance pay	\$153.3	\$79.5
Continuation of health benefits	13.4	5.6
Reemployment assistance	7.8	4.0
Total^a	\$174.5	\$88.9

^aTotals may not add due to rounding.

Severance pay varied with such factors as whether the workers were salaried or hourly employees and the length of time they had been with the corporations. Additional differences were the result of the individual contractor's worker benefit packages before the business combinations. For example, in the Hughes-General Dynamics combination, former Hughes workers received severance pay, but former General Dynamics workers did not. Also, neither the Northrop nor Vought Corporations had

severance benefits for its workers, but the Grumman Corporation did. After the business combination, therefore, former Northrop and Vought workers received no severance benefits, but former Grumman workers received the severance benefits they would have received had there been no business combination.

Services Provided to Assist Laid-Off Workers Find New Employment

The four business combinations that provided services to help workers laid off find new employment estimated they would spend \$7.8 million for such services. At the time of our review, the four companies had expended \$4 million for these services (see table 8). The cost of these services represents less than 1 percent of both the total certified and incurred restructuring costs.

Table 8: Costs for Services to Assist Laid-Off Workers Find New Employment by Business Combination

Dollars in millions		
Business combination	Estimated	Incurred
Hughes-General Dynamics	\$1.0	\$1.0
UDLP	0.7	0.2
Martin Marietta-General Electric	1.4	1.6
Northrop Grumman	0	0
Lockheed Martin	4.7	1.2
Total	\$7.8	\$4.0

The services provided to help laid-off workers find new employment fell into two categories—educational and outplacement services (see table 9). In the Martin Marietta-General Electric business combination, retraining services were provided in accordance with the General Electric layoff benefits plan. Under plant closing provisions, all former General Electric employees were eligible for up to \$5,000 tuition reimbursement for any licensed or accredited occupational or educational courses up to 3 years from the date of layoff. There was a requirement, however, that an employee start at least one course within the first year after layoff. Former Hughes employees were also provided educational benefits up to \$5,000 for attendance at an accredited college or university and the successful completion of classes that started within 1 year of the time the worker was laid off.

Table 9: Cost of Services to Help Workers Find New Employment by Category

Dollars in millions		
Benefit or service	Estimated	Incurred
Retraining and educational assistance	\$2.0	\$1.7
Outplacement services	5.8	2.3
Total	\$7.8	\$4.0

In addition to providing educational assistance, Martin Marietta also provided various outplacement services. As a result of a plant closing at Bridgeport, New Jersey, for example, Martin Marietta operated an on-site employment transition center for a 9-month period in 1994. Designed to serve 392 employees affected by the plant closing, the center provided career transition workshops, resume development, telephone and interviewing skill practice, salary negotiations, career counseling, job support groups, and job fairs. Martin Marietta incurred about \$326,000 in restructuring costs to operate the center. Martin Marietta established a similar center to assist workers affected by the closing of a facility in Conklin, New York. Restructuring costs for this center amounted to \$177,000, which included the salary costs for the center's director and counselor, equipment rentals, and telephone expenses.

Other Funds Used to Assist Laid-Off Workers Find New Employment

In addition to services being paid through restructuring costs, services were also funded by DOL grants and through normal overhead charges at the business combinations. Services funded by DOL were available to laid-off workers regardless of whether they were terminated as a result of a defense contractor business combination or normal downsizing, and some services were made available to workers from other companies. However, neither DOL, the business combinations, nor the grant recipients maintained records showing how many workers who used these services were terminated as a result of the combination.

Services Funded by DOL Grants

Many federally funded programs exist to assist laid-off workers find new employment. We reported, for example, in February 1995 that at least 163 federally funded programs and funding streams existed that provided employment training assistance, of which 9 are targeted specifically for laid-off workers.¹⁰ Among the most significant programs are those authorized by the Economic Dislocation and Worker Adjustment

¹⁰Multiple Employment Training Programs: Major Overhaul Needed to Create a More Efficient, Customer-Driven System (GAO/T-HEHS-95-70, Feb. 6, 1995) and Multiple Employment Training Programs: Information Crosswalk on 163 Employment Training Programs (GAO/HEHS-95-85FS, Feb. 14, 1995).

Assistance (EDWAA) Act. In total, the Congress appropriated about \$1.1 billion in fiscal year 1996 EDWAA grants to help dislocated workers. Funds provided under EDWAA are allocated by a formula in which 80 percent of the appropriated funds are provided directly to the states, with the remaining 20 percent reserved for the Secretary's discretion. The discretionary funds may be awarded to projects for workers dislocated due to mass layoffs, plant closures, disasters, and federal government actions.

In addition, the Congress appropriated \$150 million in fiscal year 1991 for Defense Conversion Adjustment Program (DCAP) grants, which are available to address the training and employment needs of workers dislocated by defense downsizing, including consolidation actions subsequent to cutbacks in defense budgets. DCAP grants can be awarded to states or directly to defense contractors. The Congress also appropriated \$75 million in fiscal year 1993 for Defense Diversification Program (DDP) grants to provide training, adjustment assistance, and employment services to members of the armed forces and DOD and defense contractor employees who were either involuntarily separated or laid off as a result of reductions in defense spending.

DOL officials told us they do not collect information on whether EDWAA, DCAP, or DDP funds were used to assist workers specifically laid off as a result of defense contractor business combinations. These officials indicated that some grant requests contain information that may make it possible to relate the layoffs to specific factors such as plant closings. However, they noted that service providers are not required to maintain information or report on the reasons why the workers were laid off. These officials acknowledged that because defense contractor business combinations can result from decreases in defense spending, some of the funds may have been used to assist workers dislocated as a result of these business combinations.

We identified about \$48 million in discretionary, DCAP, or DDP grants made either directly to defense contractors involved in the business combinations or to locations affected by those combinations. DOL awarded Hughes two grants totaling \$16 million to assist workers affected by downsizing in southern California, and another two grants totaling \$1.2 million to Martin Marietta to assist workers in central Florida. Another 10 grants—totaling about \$31.1 million—were awarded to 8 states that were affected by restructuring activities of the business combinations. Three of these grants, totaling \$21 million, were targeted to assist a group

of 22 defense and defense-related companies or facilities in southern California, including Northrop Grumman. A New York grant, totaling about \$5.3 million, was targeted to assist former Grumman employees. Various outplacement services were provided under these grants, including vocational and career guidance, job search assistance, and basic skills training.

Although the amount of grant funds are significant for the five business combinations we examined, DOD's guidance for preparation of the annual reports to the Congress on defense contractor restructuring activities does not require reporting any information on DOL grants. Because these grants are related to defense contractor restructuring activities, including grant information in the reports—especially on those grants made directly to contractors—would give the Congress useful information on funding available to assist workers affected by defense contractor business combinations.

Services Funded Through Contractor Overhead

Several of the business combinations operated outplacement facilities where workers could obtain assistance in finding new employment and charged the operational costs to overhead expenses rather than restructuring costs. For example, UDLP operated a center during the period 1994 through 1996 and all terminated employees—regardless of whether they were laid off as a result of the business combination or normal downsizing—could obtain assistance at the center in writing resumes, arranging for job interviews, reviewing job listings, and other related outplacement services. UDLP expended \$205,000 in operating this center during the 3-year period and paid an additional \$109,000 to a consulting firm to assist middle- and senior-level management officials find new employment. UDLP charged these costs to overhead rather than restructuring costs. Similarly, Northrop Grumman and Lockheed Martin also provided counseling and/or outplacement assistance to help workers find new employment and charged the costs to overhead expenses rather than restructuring costs.

Effectiveness of Services Provided to Help Terminated Workers Find New Employment Could Not Be Determined

We were unable to determine the effectiveness of the services provided to help laid-off workers find new employment. Like most organizations, the five business combinations we examined did not have a comprehensive system in place to evaluate outplacement effectiveness. Officials cited various difficulties that prevent them from implementing such a system. Similarly, information needed to determine the effectiveness of these services is not readily available from DOL.

Two basic elements are required in a comprehensive system for assessing the effectiveness of outplacement services: (1) criteria against which to make the assessment and (2) a tracking system to collect relevant performance information. Our work and work by DOL shows that most organizations do not evaluate outplacement services in terms of such criteria as whether those who received services are reemployed faster, received higher salaries, or were more satisfied with the jobs they found than a control group of those individuals who did not receive such assistance.¹¹ Participants at a recent workshop conducted by the Office of the Deputy Assistant Secretary of Defense (Civilian Personnel Policy) and the National Academy of Sciences concluded that no empirical work has been able to identify the aspects of outplacement programs that are the most cost-effective and useful in terms of these criteria.¹²

The business combinations we examined did not have a comprehensive system in place to track the effectiveness of services they provided to laid-off workers. Officials from Lockheed Martin, for example, told us that comprehensive tracking is difficult, especially in cases of a plant closure as there would then be no company representative on location to do the tracking. In addition, some laid-off workers do not want further contact with their former employer, making tracking difficult. Officials noted, moreover, that former employees have no obligation or incentive to report information regarding their subsequent employment status or salary information.

Similarly, information needed to determine the effectiveness of services provided to workers laid off as a result of the business combinations is not

¹¹Multiple Employment Training Programs: Most Federal Agencies Do Not Know If Their Programs Are Working Effectively (GAO/HEHS-94-88, Mar. 2, 1994); Multiple Employment Training Programs: Major Overhaul Needed to Reduce Costs, Streamline the Bureaucracy, and Improve Results (GAO/T-HEHS-95-53, Jan. 10, 1995); Workforce Reductions: Downsizing Strategies Used in Selected Organizations (GAO/GGD-95-54, Mar. 13, 1995); Employment Training: Successful Projects Share Common Strategies (GAO/HEHS-96-108, May 7, 1996); and A Guide to Well-Developed Services for Dislocated Workers, U.S. Department of Labor, Employment and Training Administration.

¹²Issues in Civilian Outplacement Strategies: Proceedings of a Workshop, National Academy Press, Washington, D.C., 1996.

readily available from DOL. DOL does not collect certain critical information, such as participant satisfaction with the position obtained or the relative success of control groups who do not participate in the programs. DOL officials stated that they did maintain information that reflects various measures of the effectiveness of DOL-funded programs at the aggregate level, such as whether program participants obtained a new position and participants' average wages before and after receiving the services. DOL officials expressed concern, however, about using their data, noting that the service providers do not always submit accurate or complete information. Finally, these officials noted that they could not provide information pertaining specifically to any of the business combinations in our review.

Comparing Restructuring Costs and Estimated Savings

Defense contractors are required to maintain accounting records showing the actual amount and nature of costs charged to government contracts. These costs are generally billed to government contracts during the same period they are incurred. As discussed earlier, however, the section 818 prohibition against payment of restructuring costs until certification of net savings creates a requirement for the contractor to segregate restructuring costs in its accounting records and to exclude these costs from any billings, final contract price settlements, and overhead settlements until the certification is made. After the certification, the contractor is then permitted to begin charging restructuring costs to DOD contracts. The contractor generally recovers restructuring costs over a 5-year period but the recoupment period may be shorter, depending on the terms of the advance agreement negotiated between DOD and the contractor.

Restructuring savings, on the other hand, are not recorded in a contractor's accounting records. Therefore, neither the amount nor the nature of the savings can be determined by reviewing the accounting records. Consequently, savings have to be estimated. For example, Northrop Grumman estimated 5-year savings from closing the Grumman corporate headquarters of about \$215 million, of which about \$100 million represents the labor and fringe costs that would be avoided over the 5-year period by laying off approximately 250 workers. These savings are therefore an estimate of a cost avoidance over the 5 years—the costs of the additional people that would have been needed had the headquarters not been closed. Savings from restructuring activities we examined were generally in the form of such future cost avoidances.

The initial estimate of restructuring savings is simple in concept because it makes the critical assumption that everything else, except for the restructuring, is the same after a business combination as before. Because things are never the same, it is difficult to precisely identify actual savings several years after the initial estimate is prepared. The December 1996 DOD restructuring report acknowledges this problem. It points out that restructuring is not the only factor that has an impact on actual costs. Other factors affecting costs include changes in the rate of inflation, fluctuations in the business base, and subsequent reorganizations.

At the request of DCMC, DCAA did a study of the estimated amount of restructuring costs paid and the estimated amount of savings realized as of September 30, 1996, for the business combinations for which DOD had allowed restructuring costs. DCAA estimated that DOD had paid \$179.2 million in restructuring costs and realized estimated restructuring savings of \$346.7 million as of September 30, 1996, for a net savings of \$167.5 million (see table 10).

Table 10: Estimates of Paid Restructuring Costs and Experienced Savings by Business Combination

Dollars in millions			
Business combination ^a	Paid costs	Experienced savings	Net savings
Hughes-General Dynamics ^b	\$124.3	\$147.9	\$23.6
UDLP	9.9	22.9	13.0
Martin Marietta-General Electric ^c	36.7	108.2	71.5
Northrop Grumman ^d	8.3	67.7	59.4
Total	\$179.2	\$346.7	\$167.5

^aLockheed Martin was not included in the DCAA study because it was certified after September 30, 1996.

^bRepresents savings on only eight contracts.

^cRepresents restructuring costs and savings from the first eight certified restructuring projects. DCAA did not project costs and savings for the five projects certified on September 17, 1996, because actual experience through September 30, 1996, would have been minimal.

^dEstimated savings are based on two of the six projects certified. These two projects accounted for 90 percent of total projected savings.

Measured another way, the figures shown in table 10 indicate that DOD has realized \$1.93 in savings for each \$1.00 of restructuring cost paid. DOD officials acknowledged that while their estimates reflect \$1.93 in savings for each dollar reimbursed, they believed additional savings were being realized. They explained that DOD had based its estimate of savings for the

Hughes-General Dynamics business combination on only eight contracts that demonstrated savings in excess of costs. They noted that documenting higher savings was not considered a prudent use of resources. An industry representative also commented that the estimates covered only the period through September 1996 and therefore do not consider savings that may be realized in future periods. It should be noted that the estimates in table 10 also do not reflect any costs that may be incurred in subsequent periods. Finally, the estimates do not reflect DOL grant expenditures or any assistance from the other federal programs or funding streams.

Of the \$179.2 million DOD has paid to these four business combinations for restructuring costs, DCAA determined that \$18 million, or about 10 percent, was charged to novated flexibly priced contracts. The \$18 million, therefore, represents the amount of additional costs to DOD as a result of its decision in July 1993 to allow contractors to charge restructuring costs to novated flexibly priced contracts. It should be noted that the 10 percent in additional costs for these four business combinations may not be representative of the percentage for future business combinations because of differences in factors that determine the percentage, including the mix of flexibly priced and firm fixed-price contracts and the period of time required for certification.

Recommendation

Because direct federal grant funds can be substantial, as in the Hughes-General Dynamics and Martin Marietta-General Electric business combinations, we recommend that the Secretary of Defense obtain information about significant federal direct grants to defense contractors involved in business combinations and include this information in the DOD annual restructuring reports to the Congress. Such information could include the grants' dollar values, purposes, and periods of performance.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD generally concurred. DOD suggested several technical clarifications, and we have incorporated them in the text where appropriate. DOD's comments are presented in its entirety in appendix I. DOL did not indicate any overall assessment of the report, but did provide several technical clarifications, which we have incorporated in the text where appropriate. DOL's comments are presented in their entirety in appendix II.

The Aerospace Industries Association (AIA) provided comments on a draft of this report on behalf of the business combinations we reviewed. AIA noted that, on balance, the report was objective. AIA offered several technical changes to clarify the information provided, which we have incorporated in the text where appropriate. AIA's comments are provided in their entirety in appendix III.

Scope and Methodology

To respond to the requirements of section 8115 of Public Law 104-208, we selected the three business combinations for which the Under Secretary of Defense (Acquisition and Technology) had issued a letter of certification as of September 30, 1996. Two additional business combinations were certified by the Under Secretary of Defense (Acquisition and Technology) on November 26, 1996, involving the Lockheed-Martin Marietta business combination and Martin Marietta's May 1994 acquisition of General Dynamics Corporation's Space System Division. We included the Lockheed-Martin Marietta combination because of the large amount of restructuring costs and savings involved in this combination, but excluded the Martin Marietta-General Dynamics combination because we were already examining two other combinations involving Martin Marietta. While the Hughes-General Dynamics business combination did not have to undergo the certification process, we included it in our review because DOD has included the combination in its restructuring reports to the Congress.

To determine the amount and nature of restructuring costs, we obtained information from each of the business combinations and DOD showing the amount and nature of certified and incurred restructuring costs at the time of our review. We analyzed the information provided by the business combinations along with DCAA audit reports and pertinent DOD and DCMC records to determine the amount and nature of restructuring costs incurred for workforce reductions and to identify the cost and nature of services provided to assist laid-off workers find reemployment. However, we did not independently verify the information provided.

We also met with DOL officials and obtained information on federal grants made to assist displaced defense contractor workers find new employment. We reviewed files for grants awarded under the DOL Secretary's discretion or under the DCAP and DDP programs that DOL officials identified as being targeted to locations in which restructuring activities were occurring. To address the issue concerning the effectiveness of outplacement services in assisting displaced workers find

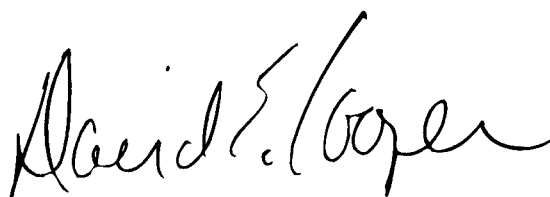
reemployment, we obtained and reviewed information provided from DOL, DOD, academia, and each of the business combinations. In assessing restructuring savings realized from the business combinations relative to the restructuring cost paid by DOD, we examined the methodology DCAA used to estimate the amount of restructuring costs paid by DOD and the amount of estimated savings. We generally found their approach and methodology to be reasonable and relied on their work to determine the estimated amount of savings realized and costs paid by DOD as of September 30, 1996.

We discussed various aspects of the restructuring costs and savings with officials from each of the business combinations, DOD, DCMC, DCAA, the DOD Inspector General, and DOL. Additionally, we provided summaries of our work to the contractors' representatives to review for accuracy.

We performed our review between October 1996 and March 1997 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretaries of Defense and Labor; the Commander, DCMC; the Director, DCAA; the Director, Office of Management and Budget; and interested congressional committees. Copies will also be made available to others upon request.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. The major contributors to this report are listed in appendix IV.

A handwritten signature in black ink, reading "David E. Cooper". The signature is fluid and cursive, with the first name "David" being the most prominent.

David E. Cooper
Associate Director
Defense Acquisitions Issues

Contents

Letter	1
Appendix I Comments From the Department of Defense	22
Appendix II Comments From the Department of Labor	25
Appendix III Comments From the Aerospace Industries Association	28
Appendix IV Major Contributors to This Report	31
Tables	
Table 1: Business Combination Certification Dates	5
Table 2: Certified Costs, Cost Ceilings, and Incurred Cost, by Business Combination	6
Table 3: Incurred Restructuring Costs by Category	6
Table 4: Projected and Actual Number of Workers Leaving Organizations as a Result of the Business Combination	7
Table 5: Estimated Costs for Benefits and Services for Laid-Off Workers by Business Combination	7
Table 6: Incurred Costs for Worker Benefits and Services by Business Combination	8
Table 7: Costs Associated With Worker Benefits and Services by Category	8
Table 8: Costs for Services to Assist Laid-Off Workers Find New Employment by Business Combination	9
Table 9: Cost of Services to Help Workers Find New Employment by Category	10

Table 10: Estimates of Paid Restructuring Costs and Experienced Savings by Business Combination	15
---	----

Abbreviations

AIA	Aerospace Industries Association
DCAA	Defense Contract Audit Agency
DCAP	Defense Conversion Adjustment Program
DCMC	Defense Contract Management Command
DDP	Defense Diversification Program
DOL	Department of Labor
DOD	Department of Defense
EDWAA	Economic Dislocation and Worker Adjustment Assistance
FAR	Federal Acquisition Regulation
UDLP	United Defense Limited Partnership

Comments From the Department of Defense



ACQUISITION AND
TECHNOLOGY

DP/CPF

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

MARCH 11, 1997

Mr. David E. Cooper
Associate Director, Defense Acquisitions Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "DEFENSE RESTRUCTURING COSTS: Information Pertaining to Five Business Combinations," dated March 4, 1997 (GAO Code 707219, OSD Case 1304).

The DoD generally concurs with the draft report. Our detailed comments on selected GAO findings and the GAO recommendation are provided in the enclosure.

Thank you for providing us the opportunity to comment on the draft report.

Sincerely,

A handwritten signature in cursive script that reads "Eleanor R. Spector".

Eleanor R. Spector
Director, Defense Procurement

Enclosure



GAO DRAFT REPORT
GAO CODE 707219, OSD CASE 1304

"DEFENSE RESTRUCTURING COSTS: INFORMATION
PERTAINING TO FIVE BUSINESS COMBINATIONS"

* * * * *

DOD COMMENTS ON SELECTED GAO FINDINGS
AND THE GAO RECOMMENDATION

Now on p. 3.

FINDING: The GAO states that for every \$1.00 DoD has paid so far in restructuring costs, the Defense Contract Audit Agency (DCAA) estimates DoD has realized savings of \$1.93. (p. 4/GAO Draft Report)

DoD COMMENT: We believe the GAO finding requires additional explanation to ensure it is fully understood. The data cited by the GAO was included in DoD's December 23, 1996 report to Congress. The DoD report set forth the estimated restructuring costs paid by DoD and the estimated restructuring savings realized by DoD through September 30, 1996, for the business combinations GAO reviewed; however, it also provided information on how the savings for particular business combinations were calculated. For example, for one business combination, the DoD report stated:

The DoD share of savings are the savings realized on eight firm fixed price contracts that were awarded after the restructuring. If other DoD contract awards were considered, DoD savings would be greater. Note that DoD has already paid its entire share of restructuring costs ... and the savings realized on eight contracts ... exceed the entire amount of restructuring costs paid by DoD.

Since this business combination was subject to the requirement that savings must exceed costs for the costs to be allowed, DoD was concerned only with demonstrating that savings had exceeded the costs. Documenting a higher level of savings would not be a prudent use of audit resources. Thus, while we have documented that DoD has realized \$1.93 in savings for each \$1.00 in restructuring costs paid through September 30, 1996, we believe additional savings are being realized as well.

Now on pp. 3 and 4.

FINDING: The GAO indicates that in July 1993, DoD changed its long-standing practice concerning charging restructuring costs to transferred (novated) contracts provided certain conditions are met. (p. 5/GAO Draft Report)

Enclosure

Appendix I
Comments From the Department of Defense

DoD COMMENT: The GAO finding requires additional clarification. Prior to July 1993, restructuring costs were usually not allowed on contracts that were transferred from a seller to a buyer after an acquisition, although they were allowed to be included in the prices of new contracts and contracts that were not transferred. In July 1993, the Department uniformly began permitting defense contractors involved in mergers and acquisitions to include the costs of restructuring business operations in the prices of all defense contracts -- including transferred contracts -- if projected savings would exceed costs. This action was consistent with the flexibility permitted by the Federal Acquisition Regulation for handling transferred contracts.

FINDING: Table 2 indicates a total cost ceiling of \$1,458.4 million. (p. 8/GAO Draft Report)

DoD COMMENT: Footnote 9 on page 8 correctly states that the ceiling costs are allocated to all contractor customers, and that DoD's portion depends on its share of the contractors' total business base. In order to ensure that this point is presented clearly, we recommend Table 2 be changed to include the estimated DoD share of the cost ceiling of \$1,458.4 million, which is \$809.3 million.

* * * * *

RECOMMENDATION: Because direct federal grant funds can be substantial, as in the Hughes-General Dynamics and Martin Marietta-General Electric business combinations, the GAO recommended that the Secretary of Defense obtain information about significant federal direct grants to defense contractors involved in business combinations and include this information in the DoD annual restructuring reports to the Congress. (p. 25/GAO Draft Report)

DOD COMMENT: Partially concur. We agree that federal grants made directly to defense contractors help provide services to workers affected by business combinations. We will meet with Department of Labor officials to determine how information on the amount of such grants provided to defense contractors involved in business combinations could be made available to DoD for inclusion in annual reports to Congress.

Now on p. 5.

Now on p. 16.

Comments From the Department of Labor

U.S. Department of Labor

Employment and Training Administration
200 Constitution Avenue, N.W.
Washington, D.C. 20210



MAR 14 1997

Mr. David E. Cooper
Associate Director
Defense Acquisitions Issues
National Security and International
Affairs Division
U.S. General Accounting Office
Washington, D.C., 20548

Dear Mr. Cooper:

Enclosed are the Employment and Training Administration's (ETA) comments on the Draft Report, "Defense Restructuring Costs."

The ETA appreciate the opportunity to review and comment on the draft report. If you have any questions regarding the enclosed comments, please contact Shirley Smith at (202) 219-5339.

Sincerely,

R. LANCE GRUBB
Chief, Division of Financial and Grants
Management Policy and Review

Appendix II
Comments From the Department of Labor

COMMENTS ON GAO REPORT -- DEFENSE RESTRUCTURING COSTS

We appreciate the opportunity to review the subject draft report and provide the following general comments. Throughout the course of many meetings and discussions with GAO staff preparing the report, a major concern we have expressed is the need to ensure that there is a clear distinction evident in the discussions of the activities of the "business combinations" vs DOL funded services and activities (and other Federal agencies) for workers dislocated by the business entities. The comments we provide suggest that there are areas in the document where this distinction is not as clear as could be.

Now on p. 2.

- o Page 3 -- second paragraph: The reference to "163 programs and funding streams" clearly needs to be related to Federal agencies, including DOL. In the same paragraph, it appears that the \$1.1 billion refers to the EDWAA appropriation for program year 1996, of which 20 percent was reserved by the Secretary of Labor for discretionary grants. Our comment to GAO staff was that DOL could not determine to what extent workers from the "business combinations" were served out of the 80 percent (formula funds) of PY 1996 EDWAA funding. DOL can and did provide the estimated number of workers from these combinations targeted for services under grants awarded from the Secretary's national reserve account (20 percent funds).

Now on pp. 2, 13, and 14.

- o Page 3 -- third paragraph: If we understand the statement as written, the reference implying that effectiveness of services for laid-off workers cannot be determined because information is "not readily available from other sources" is not exactly accurate, if this includes DOL. DOL does maintain data in the aggregate in terms of the effectiveness of services to dislocated workers. What we cannot do is disaggregate the data to reflect measures of effectiveness for only those workers terminated from the business combinations.

Now on p. 11.

- o Page 16 -- second paragraph:

The statement pertaining to DOL services as being available to assist workers being dislocated from defense contractors business combinations or normal downsizing includes the reference to "some were available to workers from other companies," which is not clear.

We indicated that administrators of JTPA Title III programs are not required to report on dislocated workers by reason of termination. However, it is possible in some cases with the national reserve account-funded grants to relate the termination to specific causal factors.

Now on p. 11.

- o Page 18 -- second paragraph: The statement should be modified to read that grantees providing services to

Appendix II
Comments From the Department of Labor

dislocated workers are not required to maintain information
on the reason for termination.

Comments From the Aerospace Industries Association



Aerospace
Industries
Association



LeRoy J. Haugh
Vice President
Procurement and Finance
(202) 371-8520

March 26, 1997

Mr. David E. Cooper
Associate Director
Defense Acquisition Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Cooper:

In response to your letter of March 18, 1997, I very much appreciate the opportunity to review your draft report on restructuring. The report addresses costs and savings associated with five business combinations, involving four corporate entities, and in particular the benefits provided to employees affected by the business combinations, and the effectiveness of those benefits. The companies involved have now authorized GAO to publish the report without proprietary restrictions, on the understanding that the work papers, segment summaries and other supporting documentation will continue to be treated as proprietary and subject to applicable restrictions.

On balance, we believe that the report is objective. However, the following comments are important to round out the picture for the uninitiated reader and avoid possible misinterpretations or erroneous conclusions, and we ask that this letter be incorporated as an addendum or appendix to the report.

1) Page 4. The first full paragraph implies that the savings of \$1.93 for every \$1.00 of cost are final figures, and that these business combinations would not meet the 2:1 ratio required by the FY97 DoD Appropriations Act. However, these estimates cover only the three year period which was reviewed, and therefore do not consider the full extent of benefits and savings expected in future periods from these initiatives. Furthermore, the companies examined were not required to meet the 2:1 ratio, which was established several years later.

2) Page 4. The first sentence of the last paragraph creates the impression that there was a significant change in practice with respect to the treatment of restructuring costs under novated contracts, after July 1993. In fact, the change was only a matter of the degree of flexibility permitted. This would be clear if the first sentence were changed to read: "The standard novation

Aerospace Industries Association of America, Inc.
1250 Eye Street, N.W., Washington, D.C. 20005-3922 (202) 371-8400

Now on p. 3.

Now on pp. 3-4.

Appendix III
Comments From the Aerospace Industries
Association

Mr. David E. Cooper
March 26, 1997
Page Two

agreement format in the Federal Acquisition Regulation generally deterred increasing the prices of flexibly priced contracts that were transferred following a business combination." The following should then be added at the end of this paragraph on page 5: "However, the FAR did provide flexibility to contracting officers to modify the standard agreement. This flexibility was further clarified by the July 1993 memorandum issued by Under Secretary of Defense John Deutch."

Now on p. 3.

3) Page 5. Following the above addition to the first paragraph ending on page 5, the lead-in to the first full paragraph should be changed to read "The July 1993 memorandum interpreted the regulations to permit defense contractors to charge . . . etc."

Now on p. 3.

4) Page 5. Footnote 5 is not accurate. It should read: "The FAR contains guidelines for determining whether certain organization costs are allowable charges to government contracts. It also describes certain organization costs, e.g., legal and consulting fees applicable to business combinations, that cannot be charged to a government contract."

Now on p. 4.

5) Page 7. The last sentence of the first paragraph suggests that the Hughes-General Dynamics combination was not subject to adequate controls or reviews. It would be more accurate to state: "The Hughes-General Dynamics business combination did not go through the certification process because it was approved prior to the certification requirement enacted in the Defense Authorization Act for Fiscal Year 1995. However, this business combination did go through audit and review."

Now on p. 5.

6) Page 8. Footnote 9 is not accurate. It should read: "Restructuring costs are allocated to all of a contractor's customers. DoD's portion depends on its share of the contractor's total business base."

Now on pp. 3 and 16.

7) The first draft of the GAO report, dated March 7, 1997, included two references to the amount and percentage of restructuring costs which were charged to novated flexibly-priced contracts. The first reference appeared just before the "Background" section, which is now on page 4, and the second just before the "Recommendation" which begins on page 25. We believe these references should be reinstated to ensure that readers have a more complete picture with respect to the impact on novated contracts, which were referred to in the July 1993 Deutch memorandum. This could be accomplished by inserting on page 4: "Of the \$179 million paid to the business combinations, DCAA determined that \$18 million, or about 10%, represented costs on contracts transferred from one company to another after a business combination." and inserting at the bottom of page 24: "Of the \$179.2 million DoD has paid to these four business combinations for restructuring costs, DCAA determined that \$18 million, or about 10 percent, was charged to novated flexibly-priced contracts."

Appendix III
Comments From the Aerospace Industries
Association

Mr. David E. Cooper
March 26, 1997
Page Three

Again, on behalf of the Aerospace Industries Association, I appreciate the opportunity to review the report and present these comments. We hope that the report will facilitate congressional and public understanding of the restructuring process and the need to continue current DoD policies regarding the allowability of these costs. The defense industry must continue to restructure and "right-size" in response to significantly reduced defense budgets, if it is to reduce costs and remain competitive in world markets. The initial costs of restructuring are recovered many times over in later savings. The taxpayers are the ultimate beneficiaries, not only of these savings, but also of the jobs that will be created by a more efficient and more competitive industry.

Sincerely,



LeRoy J. Haugh

Major Contributors to This Report

National Security and
International Affairs
Division, Washington,
D.C.

John K. Harper
Timothy J. DiNapoli
Paula J. Haurilesko
John D. Heere
Rosa M. Johnson

Atlanta Field Office

George C. Burdette
Erin B. Baker

Los Angeles Field
Office

Ambrose A. McGraw
Kenneth H. Roberts
Thaddeus S. Rytel, Jr.

San Francisco Field
Office

Ruth A. Hijazi
Donald Y. Yamada